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Taxation - Related Transactions and the Taxable Year

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RECENT DECISIONS

Taxation — Related Transactions and the Taxable Year—Taxpayers, in the years 1937 through 1940, received liquidating dividends from the corporation of which they were the sole stockholders. In 1944 they paid a judgment which had been rendered against the liquidated corporation. The taxpayers deducted the judgment paid in 1944 as an ordinary loss. The Commissioner contended that the 1944 payment was a part of the original liquidating transaction and so should have been given capital loss treatment. The Tax Court held for the taxpayer.[1] However, the Second Circuit agreed with the Commissioner and held the 1944 payment to be a capital loss.[2] *Held,* with three justices dissenting: Affirmed. The liability of the taxpayers on the judgment resulted from their being transferees of the corporation. This liability was directly traceable to the corporate liquidation. For the purposes of determining the nature of the 1944 payment, it is proper to view the 1937 through 1944 transactions as a whole. This in no way violates the established principle that each tax year is a separate unit for tax purposes. *Arrowsmith et al. v. Commissioner of Internal Revenue, 73 S.Ct. 71 (1952).*

The Court of Appeals for the Third Circuit took a position directly opposite to the rule of the principal case in *Commissioner of Internal Revenue v. Switlik.*[3] That case held that for the purposes of determining the tax treatment to be given a tax deficiency paid by the stockholders of a liquidated corporation, the payment had to be considered a separate transaction and not a part of the original liquidation. This decision was based on the court's finding that while the corporate liquidation was, so far as these taxpayers were concerned, a sale or exchange of a capital asset, the later payment of the tax deficiency assessed against the liquidated corporation was not such a transaction.

The origin of the controversy here involved seems to have been the U. S. Supreme Court decision of *Burnet v. Sanford & Brooks Co.,*[4] which first enunciated the principle in tax law now referred to as the theory of the single year as the unit of taxation. In that case the taxpayer in 1920 received payment for work under a contract which work was performed from 1913 through 1915. The taxpayer failed to include this payment in its tax return for the year 1920. The taxpayer's theory was that since operations in 1913 and 1915 resulted in a net loss, the payment in question was not taxable because under the Sixteenth Amendment and the Internal Revenue Act then in force, a tax only on

[1] 15 T.C. 876 (1950).
[2] Commissioner of Internal Revenue v. Bauer, et al., Commissioner of Internal Revenue v. Vivian, 193 F.2d 734 (2nd Cir. 1952).
[3] 184 F.2d 299 (3rd Cir. 1950).
[4] 282 U.S. 359, 51 S.Ct. 150, 75 L. Ed. 383 (1931).

net income or profits was contemplated. The court completely rejected the taxpayer's contention and held that inasmuch as taxation is necessarily based on fixed accounting periods, the payments received by the taxpayer in 1920 were income for that year. Because the payments involved were not a return of capital investment, they had to be examined alone and not in conjunction with any transactions which had taken place in prior years.

The following year the U. S. Supreme Court applied the same reasoning in the *North American Oil Case.*[5] There, the payments involved, though received by the taxpayer under a claim of right, could possibly have had to be returned as the result of pending litigation. The court reasoned that even if the taxpayer had to refund the sum in question in a later year, it would receive the benefit of a deduction in the year when such repayment was made.[6]

It appears, on the other hand, that this reasoning does not necessarily forbid the examination of prior transactions for all purposes. In the same year that the U. S. Supreme Court decided the *Sanford & Brooks Co. Case,*[7] it recognized that there are instances where a transaction, by its nature, is not a closed one, and therefore it may be necessary to examine the events which took place over a period of several years in order to properly determine the tax treatment to be given a particular payment arising out of such a transaction. The court, in deciding the *Logan Case,*[8] was dealing with a situation involving a sale or exchange of a capital asset. In dealing with capital assets our tax laws first allow a taxpayer to recoup his capital investment before being liable for any income tax. Because there may be instances where it is impossible to determine at what exact point the taxpayer has recovered his capital investment, it may become necessary to examine transactions over a period of several years and to consider them as a unit.

Then, in 1943 in *Dobson v. Commissioner,*[9] the court applied reasoning similar to the *Logan Case*[10] and went on to point out by way of dicta that the *Sanford & Brooks Case* suggested its own distinction in that it dealt with a transaction which was not the sale or exchange of a capital asset.[11]

Therefore, it has become apparent that the rule of the *Sanford & Brooks Case* does not prevent the reconsideration of transactions which by their nature are not closed. In the light of this conclusion, it can be

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[5] North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613, 76 L. Ed. 1197 (1932).
[6] *Ibid.*
[7] *Supra,* note 4.
[8] Burnet v. Logan, 283 U.S. 404, 51 S.Ct. 550, 75 L. Ed. 1143 (1931).
[9] 320 U.S. 489, 64 S.Ct. 239, 88 L. Ed. 248 (1943).
[10] *Supra,* note 8.
[11] *Supra,* note 9.

said that the rule of the principal case is logical and consistent with the principle of the single year unit in taxation as expressed by the *Sanford & Brooks Case.* It also appears that this rule affords a more realistic tax treatment where this type of transaction is involved because there is not an artificial severing of the connection between these interrelated transactions which would be required by the rule of the *Switlik Case.* Certainly to this extent, it may be said that the rule of the principal case is fair to both the taxpayer and the government.

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Damages—Similarity of Rule as to Damages in Automobile Accident and Defrauded Vendee Cases—Plaintiff brought action to recover damages for alleged fraud in connection with the sale of a prefabricated house which sold for $6500.00. Testimony of a building contractor placed the estimated value of the house, if it were as represented, between $6500.00 and $7,000.00; its estimated value at the time of the suit, between $4,000.00 and $4500.00. The contractor also testified that the house could be repaired and brought up to the value it would have had, had it been as represented, for $1700.00. The trial court entered an order granting a new trial unless the plaintiff would elect to take judgment on the sum of $1700.00, considered by the court as the lowest possible amount a jury could return as damages, instead of the $3,000.00 awarded by the jury. Plaintiff appealed. *Held:* $2,000.00 was the least amount to which the verdict should have been reduced. Order reversed unless plaintiffs consented to acceptance of judgment for $2,000.00. *Kimball v. Antigo Bldg. Supply Co., 333 Mich. 423, 53 N.W. 2d 315 (1952).*

In deciding the case the court based its decision as to damages upon the rule that a defrauded vendee, by way of damages, is entitled to the difference between the value of the thing as represented and its actual value. Purporting not to decide the question as to the admissibility of evidence of cost of repairs in determining damages, the court expressly refused to accept the supposed dual method of determining damages normally used in automobile negligence cases, i.e., reasonable cost of repair or difference in value, as advocated by the defendant and advanced in the dissenting opinion.

> A defrauded vendee has several alternatives in bringing suit. "He may elect to affirm the transaction and sue for the benefits to which he is entitled thereunder or for damages for deceit. On the other hand, he may elect to disaffirm the contract, frequently doing so by electing to rescind and be restored to his former position, recovering money paid out or recovering property, and in very many cases invoking the aid of a court of